

# *Senior Executives Association*



STATEMENT OF

THE

SENIOR EXECUTIVES ASSOCIATION

before the

HOUSE POST OFFICE AND CIVIL SERVICE COMMITTEE

on the

NEW RETIREMENT SYSTEM FOR FEDERAL EMPLOYEES  
COVERED BY SOCIAL SECURITY

23 APRIL 1985

STATEMENT OF SENIOR EXECUTIVES ASSOCIATION

At Hearing by Post Office and Civil Service Committee  
on New Retirement System for Federal Employees covered by  
Social Security  
April 23, 1985

Mr. Chairman, and members of the committee, on behalf of the Senior Executives Association, I want to thank you for the chance to express our views on the features of the new retirement system for Federal employees who are covered by social security. I am G. Jerry Shaw, General Counsel of the SEA. I am accompanied by Mr. Blair Childs, Executive Director, and Dr. Richard L. Strombotne, Chair of the SEA Task Force on Retirement Issues.

The Senior Executives Association is the professional association of the career Federal executives who are responsible for directing the programs and operations of the Federal Government under the policy guidance of the political leadership and the statutory requirements enacted by the Congress. We are concerned about the retirement system for new employees for several reasons. First, it is an important part of the overall compensation package intended to attract and retain high quality employees, at a time when that workforce is shifting toward greater professionalism and there is a continuing need to encourage careers in the Federal service. Thus it will influence the future composition and quality of the Federal

workforce that senior executives supervise and manage. Second, decisions made about the retirement system for new employees may establish precedents that will affect the current civil service retirement system (CSRS) and influence decisions by current skilled and experienced employees to stay or leave. Third, the new retirement system and changes to the current CSRS will directly affect future and current senior executives and therefore will affect the ability of the Federal government to attract and retain top notch career managers and executives.

The private sector model of retirement systems is a good one for the Federal government to follow, now that the decision has been made to include employees hired on or after January 1, 1984, under social security coverage. The General Accounting Office (GAO) report of June 1984 on features of non-Federal retirement systems is an excellent source of information for use in designing the new retirement system. It is important in this connection to recognize that the Federal Government, as an employer of professional, technical and administrative personnel, is generally competing with the largest companies and organizations in the country, not with the smallest. The GAO report needs to be read and its findings considered in this light.

The Senior Executives Association recommends that the new retirement system follow the best private sector practice in most respects, with a few exceptions appropriate for the staff retirement system of the nation's largest employer. In particular, the new retirement system should include

these three principal components:

1. social security,
2. a non-contributory defined benefit plan that is integrated with social security by the 50 percent offset method, and
3. a voluntary tax-deferred capital accumulation (CAP) plan with one-to-one employer matching of an employee's contributions up to some limit.

Our responses to the issues you identified in your letter of invitation will elaborate on this general framework of three principal components. I would like to make some broader recommendations as a preface to the specific responses and conclude with a brief discussion of several additional important topics for your consideration of changes in the retirement system.

#### General recommendations

A retirement system that is both fair and adequate is one of the most important parts of any employer's system of compensating his employees. Historically, the civil service retirement system (CSRS) has been considered relatively generous to Federal employees as a partial offset to their lower salaries when both are compared with private sector pensions and salaries. Now the CSRS is inferior to many private sector retirement systems. Moreover, changes already made to and proposed for the CSRS

greatly reduce its attractiveness. They are discouraging and demoralizing to employees who, on the average, have already devoted about 15 years of their life to public service as Federal employees after their employer, the government of the United States, has promised them the retirement benefits of the CSRS. Incidentally, I would like to point out that the average senior executive has more than 20 years of service.

More than a decade ago, Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA) to ensure that employees in the private sector would in fact receive the retirement benefits they were entitled to receive after years of work. Last year, Congress expanded the rights of private sector employees by amending ERISA with the Retirement Equity Act of 1984. It is dispiriting and frustrating for Federal employees when they see changes being made to their retirement system and their retirement benefits that Congress has forbidden private sector employers to make. We recommend strongly that Congress voluntarily pledge to conform to ERISA requirements and not take away benefits that Federal employees have earned already. In addition, we recommend that both the new retirement system and the CSRS be brought into conformity with ERISA requirements as they pertain to vesting of benefits.

As a second general topic, when you decide on the major features of the new retirement system, we suggest that you take advantage of 50 years of experience in operating the existing CSRS by amending chapter 83 of Title 5 of the U.S. Code rather than by writing a new chapter. A body of

regulations and precedents already exists to take care of many special situations that have arisen in the administration of the CSRS. We suggest that you use those precedents.

I will turn next to the issues raised in your letter of invitation to testify.

### Cost

The first issue raised is that of cost. We have three points to make in regard to the cost of a new retirement system for Federal employees.

The first is that projected costs are extremely dependent upon the precise relations among the various assumptions about future annual rates of increase in nominal interest, inflation, and average wages. In particular, the economic assumptions used in projecting the "entry level normal cost" and the "dynamic" unfunded liability of the current civil service retirement system are unrealistic. The Office of Personnel Management points out that changing the assumed real interest rate from 1.0% to 1.5%, as has been done in the most recent report by the CSRS actuaries, reduces the entry level normal cost by 5.0 percentage points, so you can see the large leverage effect of seemingly small changes in the economic assumptions. Yet, the current real interest rate, as measured by the difference between the yield on 5 year Treasury notes (more than 11%) and the inflation rate (less than 4%) exceeds 7%. Even though the current 7%

real interest rate can not be expected to persist for many years in the future, given the changes in the country's financial system of recent years, it is clear that the 1.5% real interest rate assumed by the CSRS actuaries is unsupportable. This assumption of an unrealistically low real interest rate has the effect of overstating all costs, but it especially magnifies the costs of providing cost of living adjustments (COLAs) because they occur farthest away in time and are most sensitive to discounting factors. Since the CSRS has a COLA of 100% of the change in the Consumer Price Index (CPI) and most private sector plans make only partial adjustment for inflation, the assumed low real interest rate further exaggerates the estimated normal cost of the CSRS relative to private sector plans. Further, the report of the CSRS actuaries assumes that the average rate of increase of wages for Federal employees exceeds the inflation rate, when, in fact, Federal wage increases are 25% behind the inflation rate over the last decade and there is little prospect that they will keep pace with inflation in the future. The actuaries' assumption further distorts the relative costs of the CSRS.

Our second point with respect to cost is that the retirement system must be designed to provide benefits. Specifically, the system should permit the employee who has devoted a full career of thirty years to public service, and his spouse, to maintain the same standard of living after retirement as they had before retirement. The cost of meeting this goal should be determined for different designs of the new retirement system. We recommend that the retirement system computer model of the Congressional

Research Service (CRS) to make cost projections of this kind and to provide sensitivity analyses that shed light on how the cost projections depend in detail on the economic assumptions. In particular, it should include various economic assumptions about real interest rates and relative increases of average Federal wages to cover a broad range of possibilities.

A final point on cost is that the new retirement system should not be arbitrarily limited in cost to the cost of typical private sector plans. A more generous retirement system is needed to make up for the less generous pay system. It is needed to retain experienced employees. And as already noted, the economic assumptions made in projecting future costs tend to exaggerate the cost of the Federal retirement program relative to private sector plans.

#### Social security "tilt"

The next issue is that of the social security "tilt". The percentage of final pay replaced by annuities under social security is much greater for lower paid employees than it is for higher paid employees. By contrast, the current civil service retirement system provides annuities that replace the same percentage of final average pay for both higher paid and lower paid employees having the same age and length of service.

We recommend that the new retirement system go half-way toward eliminating the social security "tilt" by using the 50 percent offset method of



integrating the defined benefit component with social security. In this method the annuity paid by the defined benefit plan is reduced by one half the amount of the social security annuity. This is the system used predominantly by private sector pension plans. Voluntary contributions to the CAP will have to be used by higher salaried employees to make up for the lower rates of replacement of final salary they will receive from the combination of social security and defined benefit plans.

We further recommend that the "offset" to the annuity paid by the defined benefit plan be delayed until age 62, which is the age when any earned social security annuity first can be received. Moreover, the amount of social security annuity to be offset should be determined by the portion of the social security annuity that was earned as a result of Federal employment, not total employment. This point is important for employees who have substantial career experience in non-Federal employment.

In addition, we recommend that the retiree be given the option of leveling out the annual total of annuities from social security and the defined benefit plan before and after age 62. If the retiree wants to have such a level payment option, he could pay for it either by taking a reduction in pension after age 62 or by using some of his account in the capital accumulation plan.

#### Employee contributions

With respect to the issue of employee contributions, we recommend that the private sector model be followed. Specifically, this means:

- (1) employee and employer pay equal contributions to social security;
- (2) employer pays full cost of defined benefit plan with no employee contribution; and
- (3) employer matches employee's voluntary contributions to tax deferred capital accumulation plan up to a limit. In addition, an employee can make contributions up to a higher limit. We recommend that the matching ratio be one-to-one up to an 8% limit and that the limit for the sum of employer's and employee's contribution be 20% of statutory pay.

The one-to-one matching ratio for contributions to the capital accumulation plan provides a strong incentive for a high percentage of all employees to participate. The eight percent limit provides employees with an opportunity to save for additional retirement benefits as they see their own needs. The non-contributory defined benefits plan follows the practice of the vast majority of such plans in the private sector.

Virtually all employee groups in the country potentially have access to some kind of tax deferred retirement savings plan. Indeed, even nonprofit organizations can provide 401(k) profit sharing plans for their employees, as the April 29, 1985 issue of Forbes points out. Federal employees have not been included as yet. We recommend that all Federal civilian and

military employees be provided with the opportunity to contribute to a tax deferred capital accumulation plan, not limited to the new employees, and that the contribution limit be set at 20% of statutory pay. This change would remove an oversight that has become a gross inequity. Note that we are not recommending any employer matching of an employee's contributions, except in the new retirement system.

### Vesting

With respect to the issue of vesting we make these recommendations:

The vesting period for the defined benefit plan should be five years, the same period as the current CSRS. This period is conducive to mobility of employees to the Federal Government from the private sector and vice-versa. The 10 year period used by many private sector firms results in many employees spending many years with companies without ever becoming vested.

For the voluntary tax-deferred capital accumulation plan there are two vesting periods to consider. The employee should have immediate vesting in his own contributions and earnings thereon. He should be vested in the employer's matching contributions and earnings thereon on a graduated schedule, leading to 100% vesting after five years of employment and starting with 25% vesting after two years. This vesting schedule gives new employees additional incentive to become long term rather than short term employees. It also avoids wasting pension resources on people who are

employees for a year or so and then leave. Note that a person's years of employment with the Federal government, not his years of participation in the new retirement system, should be the criterion for vesting of the employer's contributions. This point is an important one for an employee who transfers from the current system to the new one.

### Funding and financing

With respect to the issue of the funding and financing of new retirement system we have several observations.

The first observation is that in an overall sense it does not make any difference whether the individual agencies or the Treasury have to pay the employer's costs of the retirement system since the funds come from the same ultimate source. Practically, however, the immediate source of financing might have a very large effect on the programs and operations of individual agencies until the new retirement system has been in operation for several years and people are able to estimate its annual cost. This is particularly true when the number of participants in the new retirement system is growing quickly, they have discretion with respect to the amount they contribute to the capital accumulation plan, and the amounts of the employer's matching contributions are uncertain. In this case, it might be advisable to require the Treasury Department to make up any differences between actual and projected costs for the first five years of operation of the new retirement system.

The second observation is that, as a matter of principle, full funding of the entry level normal cost of the new retirement system would be an excellent way to make visible the actual costs to the U.S. Government as employer of its personnel.

A third observation is that the CSRS trust fund today has one of the best ratios of balances to outlays of ten Federal trust fund accounts reported in the 1984 Statistical Abstract. For 1983, the balance in the CSRS trust fund covered 5.2 years worth of outlays. By contrast, the social security trust fund balance barely covered 10 weeks of outlays. The rather healthy financial condition of the CSRS trust fund has not prevented criticism of the financing of it.

A final point is that, under the concept of the unified budget, money owed by the government to itself is simply an exercise in bookkeeping. In any year the real costs of employee compensation are disbursements to retirees and survivors as deferred pay for past services, disbursement to employees in partial payment for current services, and administrative expenses.

#### Special Category employees

We have several observations regarding the retirement system for special category employees, namely fire fighters, law enforcement officers, and air traffic controllers.

First, it is reasonable to continue the practice of offering early retirement opportunity to these employees. This practice is common among non-Federal employers for fire fighters and law enforcement officers. There is no private sector counterpart to an air traffic controller, but we see no reason to change past Federal practice regarding early retirement for these employees.

For reference, our recommendations regarding normal retirement are as follows:

Voluntary retirement at the usual combinations of:

- (a) 30 years of service and 55 years of age,
- (b) 20 years of service and 60 years of age,
- (c) 5 years of service and 62 years of age.

Involuntary retirement (or voluntary early retirement under special conditions at:

- (a) 20 years of service and 50 years of age or
- (b) 25 years of service and any age.

Penalty on annuity from defined benefit plan of 2% per year for each year prior to age 55. All of these provisions are identical to those of the

current CSRS.

In addition, we recommend the establishment of a special optional retirement at age 55 with 10 years of service but with a nominal actuarial penalty of 6% for each year before age 62.

For the special category employees, we recommend that there be no early retirement penalty before age 55 and that the 50 percent offset feature of the defined benefit plan be delayed until age 62 when eligibility for a social security annuity begins. In these cases, just as for other retirees, there should be no supplement to make the total annuity before age 62 equal to the total annuity from social security and the defined benefit plan together after age 62. If the retire opts to use a "leveling" feature on his earned annuity from the defined benefit plan or uses a lump sum from his capital accumulation plan account to pay for it, he could achieve an annuity that did not change dramatically with age as social security phases in.

This completes our responses to the issues from the letter inviting us to testify today. In addition, there are three important issues for your consideration of the retirement system for new employees we will discuss briefly.

#### Administration of Capital Accumulation Plan

In consideration of how the new retirement system is to be administered it is apparent that the defined benefit component can be viewed as a variation on the current CSRS and that OPM is the appropriate agency to administer it. The new capital accumulation plan (CAP) is, or should be, a different matter. We recommend that a separate independent organization be formed to administer the CAP for the benefit of its participants, that is, current and past employees and annuitants. The Pension Benefit Guarantee Board is an example of an agency set up to make investments of pension funds.

The CAP should be administered to provide a high degree of participant choice with respect to investment manager, to types of investments, and to allocations of past and current contributions. As an example, a private sector employee typically can select an investment manager as the recipient of contributions to a CAP and then may choose to allocate his contributions to one or more of several types of investments.

In addition, careful attention needs to be given to the appointment authorities and to organizational matters to ensure that the administration is performed objectively, fairly, and without partisan bias.

### Survivor Benefits

Benefits to survivors of employees and annuitants are very important considerations for employees. Consequently the survivor benefits aspect of the new retirement system deserves serious attention. First, the



availability and level of benefits to survivors in the new system should not be less than in the CSRS.

Second, particular attention should be given to the transition period when many employees may not qualify for benefits under social security.

Third, the new system should conform to any requirements imposed on private sector plans by ERISA and the Retirement Equity Act in regard to survivor benefits. In particular, the survivors (or beneficiaries having an insurable interest) of a separated employee with a vested right to a deferred annuity at age 62 should have the option of a lump sum payment or an annuity, appropriately adjusted for actuarial factors. This is not true of the current CSRS.

Fourth, the provision of the current CSRS for joint and 50% survivor annuity at a cost of 2 1/2% reduction in the first \$3600 of annual annuity payments and 10% of annual payments above \$3600 should be retained in the new system and used as the basis for any further actuarial adjustment needed for other options. It is a reasonable balance between the individual employee having to completely fund the survivor annuity and the employee having to fund none of it.

#### Changes to current CSRS

Although the focus of attention today is on issues pertaining to the design of a new retirement system for Federal employees covered under

social security it is appropriate to point out that the new system will not exist in isolation. There are some improvements that can and should be made to the current CSRS. Many of the improvements have little or no cost in the larger sense but would make a difference for individual employees and annuitants.

I will give two simple examples. First, annuitants could be given a wider range of options for joint and survivor annuities. Second, the special optional retirement at age 55 with 10 years of service but with 6% penalty for each year before age 62 to reflect full actuarial costs that was proposed for the new system could be included in the current system.

We would be happy to give you additional suggestions for the record and to discuss them with the Committee staff.

### Conclusion

Mr. Chairman, this concludes my prepared testimony. We will be happy to work with your staff to develop these recommendations further or to discuss other topics concerning the retirement system for Federal employees generally or for senior executives specifically. If you have any questions now my colleagues and I will be pleased to reply.